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ences in the customers' rate in different sections of the country.

From a practical standpoint the control of credit is largely a matter of leadership and example. It is becoming clear that each rediscount application in a Federal Reserve Bank must receive a high degree of individual study and that there must be devoted to it a specialized judgment which takes full cognizance of all the facts surrounding it. In western Reserve Banks, at least, it is improbable that the conditions of any two borrowing banks will prove to be exactly parallel. These differences must be recognized and as they develop they call for keen banking judgment rather than the application of a rule. In the last analysis the control of credit through the Federal Reserve System is, therefore, a matter for the executive officers and executive committee in each individual case. They must set up their own policies, form their own judgments, and endeavor to hold all applications from borrowers to proper standards, which if they are to be valuable must not be inflexible. From an intimate viewpoint it is clear that the success the Federal Reserve Banks have had in enabling this country to avoid disaster, while not complete, was still extraordinary and that it had its foundations not in any question of rate control but in the application of shrewd and precise judgment to many thousands of separate and distinct problems.

In checking expansion, the promptness and courage of the Federal Reserve Banks in taking a stiff stand against inflation is likely to prove more efficacious than any decision to advance the rate, although both actions must go hand in hand. In reality it might be said that an advancing or receding discount rate is of material advantage as a warning signal but that the practical work of the Federal Reserve Bank is in its executive committee and that the degree of control which it exercises, which is necessarily limited by the insufficiency of its membership, will be proportionate to the farsighted vision and courage of the Federal Reserve Board, which supervises, and the executive control in each Federal Reserve Bank, to which each problem must ultimately come for settlement.

Principles Governing the Discount Rate[1]

By W. P. G. HARDING

Governor of the Federal Reserve Board

CONTROL over discount rates, as exercised by the Federal Reserve Banks and the Federal Reserve Board, is one of the most important and far-reaching powers ever delegated by Congress to another instrumentality. The grant ranks with the power given the Interstate Commerce Commission to regulate railroad rates. While it is necessary that powers of this kind should be vested in a few hands, they should be used with discretion and the effect of a change in rate should be carefully considered before the change is made.

The principle is well established that in theory the Federal Reserve

[1] Remarks at the opening session of the joint conference of the Federal Reserve Board with the Federal Reserve Agents and Governors of Federal Reserve Banks held at Washington, D. C., October 25–28, 1921.

Because of his official position, Governor Harding did not feel at liberty to express a personal opinion. In this paper, however, he states the problem as it has been brought before Federal Reserve authorities.

Bank discount rate should be slightly in excess of current rates. There has been much discussion of the reductions which have been made in discount rates during the last six months and, disregarding the opinions of the prejudiced and the uninformed, let us consider the conflicting views of some whose opinions are worthy of attention and respect.[2]

VIEWS ON REDISCOUNT RATES

A New York banker and an eastern economist expressed themselves as follows:

> The basic idea in this policy of keeping the rediscount rate above the market is that Reserve Bank money is for exceptional and unusual use—that it is not the province of a Reserve Bank to supply a substantial part of the ordinary funds employed in the market in ordinary times. Of course, it is expected that a Reserve Bank shall make money for its stockholders and shall employ such of its funds as may be necessary to meet expenses and to pay dividends. One provision of the Federal Reserve Act, permitting open market operations on the part of the Federal Reserve Banks, was designed to give them discretion in this matter, whether the member banks should rediscount with them or not. But the position of a Reserve Bank is a very peculiar one. If an ordinary bank makes a loan, checks come in against it, as a consequence of the loan, which it must meet out of its reserve unless it should happen that, simultaneously, new deposits are made with it of checks drawn on other banks. Loans made by a Reserve Bank, however, need not lead to drains on its reserve. When, in making a loan, it issues its notes or gives a deposit credit to a rediscounting bank, that note or a transfer of that deposit credit will be accepted as ultimate payment by some other institution. The deposit liabilities of the Reserve Bank count as ultimate reserve for the other banks of the country, and the volume of reserve money is consequently increased through a mere increase in the deposit liabilities of the Reserve Bank. With an increase in the volume of reserves of the member banks, there is an immediate tendency to a reduction in the general level of discount rates throughout the country, placing them below the level which open market conditions would otherwise call for and creating a temptation for the uneconomical use of bank funds. There is particularly a temptation to use bank funds in an excessive degree for capital purposes, and for the ordinary banks of the country, misled by the artificial excess of liquid cash, to tie up too great a part of their assets in non-liquid form. The Reserve Bank which makes rediscount rates too low, therefore, instead of performing its function of increasing the liquidity of the banking system, tends rather to destroy liquidity.

A Chicago banker reiterates the opinion, expressed by him several times, that the Federal Reserve Banks and the Federal Reserve Board ought to proceed very slowly in lowering the present rates. He anticipates that there is considerable danger, in case the rates are lowered precipitately, of a renewed inflation, with a consequent reaction more violent than that through which we are now passing. He takes the view that, in general, it is a complete mistake to have the rediscount rates lower than the prevailing market rates for commercial loans, for if banks are enabled to rediscount their paper at a lower rate than they themselves receive, obviously a continued inflation is profitable to them. His opinion coincides with the views of the eastern banker and the economist above quoted, and he stresses the point that our large gold reserve is, after all, due only to the fact that gold is not being circulated at the present moment and that much of this gold is likely to flow out of the country as soon as there is a change in the bal-

[2] The quotations which follow are from a symposium recently published in a financial journal.

ances of trade. He concurs, also, in the view that a certain amount of the gold which the Federal Reserve Banks have at present is, in a sense, merely held in trust for Europe. He regards as entirely fallacious the argument made by adherents of a policy of lowering rediscount rates that such action is desirable because the reserve ratio and gold accumulations of the Federal Reserve Banks justify a relaxation of the official rates.

A Milwaukee banker who contends that the policy should be in accord with the money market tendency, states:

> The main point made by those opposed to the lowering of Federal Reserve discount rates is that the rediscount rate should always be above the market rate. This is laid down as a general principle to which there are no exceptions. Federal Reserve funds are only emergency funds, it is said, and it should not be possible for banks to make a profit by rediscounting at a lower rate than the market.
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> When the demand for credit is excessive and increasing, the Reserve Banks should move into a dominating position by raising their rates above the market rates for money. But the same necessity for discouraging resort to Federal Reserve Banks does not exist when the demand for credit slows down, loans are being paid off and reserves are accumulating. What has happened as a result of the recent lowering of rediscount rates? Has it resulted in an expansion of loans or reinflation? Not at all. On the other hand, the published records show that member banks have continued to reduce their rediscounts and borrowings and to do this have brought pressure upon their customers to liquidate. Customers who have voluntarily liquidated and got themselves back into good financial condition are offered lower rates on new loans. This, of course, is an incentive to those who have not done so to liquidate. This is the practical way in which the leadership of the Federal Reserve Banks in reducing their rates has worked. There has not been the slightest tendency toward renewed inflation. Rather the tendency has been to further liquidation. . . . The general principle of keeping Federal Reserve rediscount rates above the market rate for money is sound, but it does admit of exceptions as in the present condition of things. The present Federal Reserve policy is in accord with the tendency of the money market and it is hard to see how it has had, or will have, any but a wholesome and constructive effect.
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> In a recent publication a well-known banker and economist has asserted that the best index of the money market in this country is the rate on line-of-credit loans to borrowers from two or more banks, and not the rate on bank acceptances, as in England. The volume of line-of-credit loans in this country is far larger than the volume of bank acceptance credits, but it may be doubted whether the rates on such loans are as competitive as bank acceptance rates. Bank acceptance rates are fixed in the open market and are published. Line-of-credit loans have no open market and there are no published rates. Line-of-credit loans are not as competitive as they may seem. A small firm commonly maintains a line of credit only at its own bank. Large corporations usually have lines of credit not only with their home banks but with large banks in financial centers, not necessarily because they can secure lower rates, but because no one bank wants to take care of their full needs. For these reasons it is to be doubted whether line-of-credit loans afford as good an index of money market tendencies as the bank acceptance rates. The latter represent the minimum rates for the best class of paper and, because this is so, they indicate far beyond their actual money volume the drift of the market. The present rate on eligible bank acceptances of $5\frac{1}{8}$ to 5 per cent is a better indication of what is taking place and what may be expected in the open money market than rates on line-of-credit loans which reflect market condition more slowly.

Another Chicago banker takes an extremely conservative view. He would like to see many of the so-called "war amendments" to the Federal

Reserve Act repealed and states that as the law stands, "nothing but the courage and wisdom of the management prevents it from becoming a disastrous engine of inflation." He objects particularly to the amendment which forces member banks to carry their entire lawful reserves in the form of collected balances with the Federal Reserve Banks and believes that this amendment, which he regards as practically demonetizing gold, is most dangerous in normal times. Referring to the complaints which have been made that the agricultural districts have been discriminated against, he believes that exactly the opposite is the case and appears to believe, also, that the Federal Reserve System has worked a great injury to the country as well as inestimable benefits. He states:

In a time of inflation such as we had a year ago, it nullifies the operation of the usual normal remedies for such conditions. If it had not been for the Federal Reserve Banks, farmers generally would have been compelled to sell their crops a year ago and pay their debts. This would have saved them and the country from the disaster that has overtaken them. Also, had it not been for the Federal Reserve Banks, manufacturers and merchants would have been unable to accumulate or carry the heavy inventories entailing losses in a single year which it will take a generation to replace.

The solution to this is to keep the Federal Reserve discount rates above current market rates, so that there will be no temptation on the part of the member banks to profiteer through the Federal Reserve Banks. So long as the Federal Reserve rates are kept below current rates, there is, in my judgment, no way in which this kind of inflation can be prevented. On the other hand, if borrowers compel their banks to rediscount in order to enable them to carry crops or goods for higher prices, they are put on notice that they are acting against the general judgment. In normal times member banks should understand that they are not expected to borrow except to meet emergencies, and they should be made to feel that borrowing at such times is an indication of weakness and needs explanation.

He expresses the hope that the Federal Reserve Board will make a public statement of what its future policy will be regarding rates and expresses the belief that the confidence of the country in the Board is such that any clear statement of fundamental principles made by it would be acquiesced in.

Another New York banker while convinced that under normal conditions it is logical that the Federal Reserve rate should be higher than the prevailing commercial rate, believes that in view of the world-wide conditions that exist today, the adoption, at this time, of artificial means to accelerate the process of readjustment would be a dangerous course to pursue. He states:

Considering the extent to which credit for speculative purposes has been liquidated, and also taking into consideration the present reserve and gold position of the Reserve Banks, it would seem that the reduction in rate is fully justified. Furthermore, I do not believe the reduction at this time in the rate will appreciably encourage a tendency toward renewed credit inflation. The question of rates has, on the whole, been ably and courageously handled by the Federal Reserve Banks and the Federal Reserve Board.

He says that if he were to offer a critical observation, it would be to remark upon the "salutary modification of the need for deflation that would have resulted had the high rates been put into effect in the spring of 1919 instead of the summer of 1920."

A Boston banker takes the view that the Federal Reserve System was

organized for the purpose of furnishing credit, by means of rediscounting, to the commercial banks of the country. He says:

> In a general way the time when this credit is needed is just before, during and immediately after, a credit crisis, or credit pinch, and it seems clear that at such time the rate charged for rediscounting should be at about the current market rate charged by the commercial banks to their customers. To make the rate higher than the prevailing rate would tend to restrict the granting of necessary credits to merchants and similar borrowers. To make the rediscount rate much lower than the prevailing rate would tend to encourage over-loaning by the commercial banks. In fixing the rediscount rates, the managers of the Federal Reserve Banks should try, as far as possible, to keep their minds free from influences other than those which directly concern the prevailing rates of money, but they certainly are justified, when fixing rediscount rate, in being influenced by motives of the safety of the Federal Reserve Banks themselves, and when the rediscounts appear to be approaching a dangerous total, they should use their rate-fixing power to check speculation and to prevent any possible danger to the Federal Reserve Banks, which are the foundation of our whole banking system. It was never intended, and never should be intended, that the Federal Reserve Banks consciously use their power and authority either to encourage or to discourage business. Their chief purpose should be to assist commercial banks and to fix the rates of rediscount so as to best accomplish this, and at the same time to protect their own position from any possible overstrain.

He regards as one of the greatest dangers to which the Federal Reserve System can be subjected, the attacks and manoeuverings of politicians to make the System serve political ends.

Another leading banker does not believe that the time has yet arrived when discount rates should be held up to a point above the rates for commercial paper because the conditions of business are not yet on a normal basis. He says that it has been the habit of commercial bankers to argue with their commercial customers that the rate to their customers is based on the Federal Reserve Bank discount rate and that it should be enough higher than the discount rate so that there would be a profit to the banker between the discount rate and his rate to his customers. He says further:

> There is yet in our banks a large amount of so-called frozen loans which may be described as loans which are probably good but which the borrowers are not in a position to pay off at the present time. Therefore, they are not in a position to trade on market rates on an even basis with the banker. Under these conditions, a high discount rate of the Federal Reserve Banks simply has helped the commercial banker to get higher rates from his customers than are justified by the conditions of credit. Therefore, it was desirable and necessary for the Federal Reserve Banks to reduce their discount rates from 6 or 7 per cent to 5½ per cent in order to inform the commercial community that the credit situation no longer demanded these high rates.

He takes the view that "Federal Reserve Bank discount rates should not be made with the idea of controlling business or market prices of commodities," but that "they should be indications of the effect that the present business is having on the supply of credit and of anticipated conditions that will affect the supply of credit in the near future." He believes that "when the business community has become trained to the point of watching the reserve position and discount rates of the Federal Reserve Banks and has come to an understanding of what these figures mean, it will be helped very much

by studying the published conditions of the Federal Reserve Banks and will appreciate what a change in discount rates means, provided of course that the officers and directors of the Federal Reserve Banks are not hampered in using their judgment in these matters by outside influences."

A Chicago merchant notes the difference of opinion among experts as to the proper time for raising or lowering the Federal Reserve rediscount rates. He points out that neither the Federal Reserve System nor any part of it can be run on any formula, and that if it could, very little brains would be required for that part after the formula had been found. He believes:

> If we are to be a world power in commerce, as we may be, we shall have to make the New York, or some other district rate attractive for the discount of the world's import and export bills. We might, of course, be above the English rate for a short time, for adjustment or other purposes, but if we make a rule to have the rate always above the commercial paper rate in New York, our ambition to be the world's bankers, or to compete with England in commerce and finance, will vanish into thin air.

He takes the view that in crises and extraordinary emergencies a Reserve Bank may well be justified in violating temporarily the ordinary canons of sound finance, but emphasizes the fact that under normal conditions and under conditions when it is possible to take a long-run view, the well established traditions covering a Reserve Bank's operations must be followed. The chief of these canons is that the rediscount rate of Reserve Banks should be kept above the market.

Recommendation of Advisory Council

The Federal Advisory Council, at its last meeting on September 20, 1921, expressed its belief that rates should bear a direct relation to a Federal Reserve Bank's reserve and to the general money market, and that, in addition, consideration should be given to the items enumerated in the Council's recommendation of May 17, 1921, as follows:

1. The reserves of the Federal Reserve System as a whole.
2. The reserve position of the Federal Reserve Bank whose rate it is contemplated to change.
3. The condition of all the banks of the country as a whole, and of the several Federal Reserve districts.
4. The economic and financial condition of this country.
5. World conditions, both economic and political.
6. The eventual establishment of a credit rate policy for the Federal Reserve Banks by which the rediscount rate to member banks is higher than the prevailing commercial rate, taking due consideration of the prevailing open-market rates for various classes of loans both in this country and abroad.
7. Uniformity of rates, while at times practicable and desirable, should not be adopted as a fixed policy, the System being predicated upon the principle that varying conditions might exist in different sections of the country.

With reference to the general money market, the following factors were suggested by the Board as those which should be considered in arriving at a conclusion as to what is the current rate for money:

1. Rates charged by banks to their regular customers.
2. Rates for one-name paper bought through note brokers.
3. Open market rates on bankers' acceptances.
4. Rates on Treasury certificates.

The Board asked the Council for its views as to the relative importance of each of these factors and the Council expressed the view that all four items

mentioned are important in determining the money market but there may be other factors which should likewise be given consideration, such as general business conditions and the reserve position of a Federal Reserve Bank. It was the view of the Council that the ruling rate for money in a district will adjust itself automatically to these conditions. The Council expressed the view, also, that a Federal Reserve Bank while it is borrowing should not lower its rate, but stated that special conditions might exist in a district which would make a reduction desirable and would justify such a course.

REDISCOUNT PROBLEM CONFRONTING THE BOARD

It seems clear to the Board that it is not practicable in this country for Federal Reserve Banks to maintain rates of discount higher than current market rates if line-of-credit loans are to be accepted as the criterion. The rates of interest permitted in many states are so high as to preclude this as a possibility. In ordinary circumstances when the credit risk is at a minimum the rates paid for high grade commercial paper sold in the open market may be regarded as a measure of the market rate for money, but it is evident that at present there is much consideration to be given to the basis on which short time obligations of the Treasury are sold and to market rates for prime bankers' acceptances. The problem, therefore, is more simple at this time in districts like New York, Chicago and Philadelphia, where the Federal Reserve cities are dominant in their districts; but in other districts which cover a larger territory and where the business is more distributed and diversified, the problem is more difficult. At the present time, four Federal Reserve Banks are rediscounting about $45,000,000 with three other Federal Reserve Banks. The directors of one of these borrowing banks more than a month ago voted to reduce their discount rate from 6 per cent to $5\frac{1}{2}$ per cent on all classes of paper, but the Federal Reserve Board has not yet approved the reduction. No evidence has been presented to show that current rates for bank accommodations are less than the Federal Reserve Bank rate, or that current rates would be reduced by lowering the Reserve Bank rate, but the directors argue that the consolidated reserve position of the System justifies a lower rate.

The Board has been inclined to the view that the reserve percentage of each Federal Reserve Bank, as well as that of the System, should be taken into consideration as one of the determining factors in fixing the discount rate. If the Federal Reserve Bank of Chicago, with a reserve of around 70 per cent and the Federal Reserve Bank of St. Louis, with a reserve of 63 per cent do not feel justified in reducing their discount rates below the present level of 6 per cent, what argument is there for a borrowing bank, like Atlanta, having a reserve without rediscounts of only 32 per cent, to have a $5\frac{1}{2}$ per cent rate? On the other hand, what are the arguments against a reduction in districts which have so high a percentage of reserve?